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Taxation - Federal Income Tax - Published Opinions of the New Tax Officialdom: A Review

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TAXATION — FEDERAL INCOME TAX — PUBLISHED OPINIONS OF THE NEW TAX OFFICIALDOM: A REVIEW — President John F. Kennedy has appointed as his principal tax officials two men who have long been on record as proponents of tax reform. This comment is a collection and, to a small extent, an analysis of the opinions found in their published statements on taxation.¹ Stanley S. Surrey, fifty-year-old Assistant Secretary of the Treasury for Tax Policy, first served with the Treasury Department in 1937. He was Tax Legislative Counsel from 1942 to 1947 and later served as Special Counsel to the House Ways and Means Subcommittee on Administration of the Revenue Laws. He also has served as Reporter of the American Law Institute Tax Project and as a member of the Shoup Mission, which revised Japan's tax system after World War II. Mortimer Caplin, a forty-four-year-old professor at the University of Virginia Law School when he was appointed Commissioner of Internal Revenue, is a member of the Tax Advisory Group of the American Law Institute. The two men have remarkably similar views on the general situation of the federal income tax today and on most of the reforms they advocate. Both fear a present and impending emasculation of the Internal Revenue Code by popular disrespect and a gradual narrowing of

¹ This comment does not cover in general the opinions of either official on taxation of income earned abroad, or the estate and gift taxes.

its base.² The two factors, in their opinion, reinforce one another. Widespread lack of confidence in the essential fairness of the tax makes it easy for Congress to create tax shelters for pressure groups. Tax shelters for pressure groups, and the complex code provisions which they require, create further dissatisfaction. A two-pronged attack on the problem is proposed: first, elimination of tax shelters by legislation, litigation, and stronger enforcement; second, a reduction in rates to eliminate unfairness and congressional sympathy for high-bracket taxpayers.

I. THE ROLE MR. SURREY INTENDS TO PLAY

Mr. Surrey has clearly outlined the active role he believes the holder of his office should play.³ Mr. Caplin has published no opinions on the proper function of the Commissioner. Believing that tax policy and tax administration cannot and should not be separated, Mr. Surrey favors close coordination of Treasury policy and Bureau administration, with top-level contact between the Treasury and the Bureau primarily his responsibility. Aside from this coordinating function he feels that it is a prime responsibility of his office to oppose effectively pressure groups which urge creation of tax shelters. He believes the Treasury must be an outspoken champion of tax fairness, which he believes is embodied in a progressive tax with equality within brackets.⁴ He probably can be expected, in the course of performing this function, to give broad publicity to the low amounts of tax actually paid by certain high-income groups and to recommend legislation requiring that special proposals benefiting small groups be presented in the form of private relief bills.⁵ Mr. Surrey's previous Washington experience should be of considerable value to him in his forthcoming struggles with the lobbyists.

Mr. Surrey's publications indicate, although this is difficult to substantiate by direct quotation, that where the statute is not precise he would favor more aggressive Treasury action toward developing new substantive tax law through the administrative

² The tax base is, roughly speaking, that income to which the ordinary income rates fully apply after taking into account the effect of exemptions, deductions, exclusions, income separately taxed and credits against tax. Caplin, *Threats to the Integrity of Our Tax System*, 44 VA. L. REV. (1958); Surrey, *Do Income Tax Exemptions Make Sense?* 102 CONG. REC. A3053 (1956).

³ Surrey, *Comment on the Proposal To Separate the Bureau of Internal Revenue from the Treasury Department*, 8 TAX L. REV. 155 (1953).

⁴ Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145, 1164 (1957).

⁵ *Id.* at 1172, 1180.

and litigation processes.⁶ Mr. Caplin, on the other hand, may favor a closer adherence to the precise words of the statute, with less administrative emphasis on "substance over form." At least he has argued in this direction in the context of the thin-incorporation doctrine.⁷

II. REASONS FOR ATTACKING TAX SHELTERS

It is Mr. Surrey's thesis that Congress has maintained the present high rate structure at the behest of certain pressure groups, and that it points to the rate structure in defense when its other tax legislation is attacked by those groups.⁸ However — his argument goes — Congress does not actually believe in high rates and promptly emasculates the rates by creating tax shelters which are not equally available to all taxpayers within a given rate bracket. Both Mr. Surrey and Mr. Caplin believe present upper-bracket rates are unfair because they are too high.⁹ For the most part their attack on tax shelters is based upon the inequities created within rate brackets and the complexity caused by the shelter provisions.¹⁰ Occasionally, however, one or the other will move toward an attack on the shelters solely because they enable the rich to escape paying taxes.¹¹ This latter viewpoint is somewhat inconsistent with Mr. Surrey's thesis that the shelters were intentionally created by Congress to mitigate the effect of rates he admits are too high.

III. PROPOSED CHANGES IN ENFORCEMENT

Along with changes in substantive law, the new officialdom wants tougher enforcement by an expanded and strengthened Revenue Service.¹² In April the Kennedy administration asked Con-

⁶ See generally Surrey, *supra* note 3. See also Surrey, *Memorandum Regarding Certain Items in the List of Substantive Unintended Benefits, Hearings on Technical Amendments to the IRC Before a Subcommittee of the House Ways and Means Committee*, 84th Cong., 2d Sess., vol. 5, at 436 n.1 (1956).

⁷ Caplin, *The Caloric Count of a Thin Incorporation*, 43 MARQ. L. REV. 31, 54 (1959). But cf. Mr. Caplin's implied praise of judicial destruction of avoidance devices based on the letter of the code. Caplin, *supra* note 2, at 841.

⁸ Surrey, *supra* note 4, at 1150; Surrey, *Do Income Tax Exemptions Make Sense?* 102 CONG. REC. A3053, A3055 (1956).

⁹ Caplin, *supra* note 2, at 844, 845; Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 935, 1016 (1956).

¹⁰ Caplin, *supra* note 2, at 839, 840. Surrey, *supra* note 4, at 1146, 1152.

¹¹ See, e.g., the criticism by both gentlemen of the dividends received credit. Caplin, *supra* note 2, at 845; Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 820, 821 (1958). See also Surrey, *supra* note 4, at 1179.

¹² Caplin, *supra* note 2, at 852; Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 827-28 (1958).

gress for thirty-four million dollars to hire 4265 more Internal Revenue Service employees, and Attorney General Robert Kennedy has announced plans to increase the prosecution of tax evasion cases.¹³

The enforcement proposals of Mr. Surrey and Mr. Caplin are threefold: broader reporting requirements, greater withholding requirements, and more careful auditing by an expanded Revenue Service. Mr. Surrey would require more reporting from executives, employers, entrepreneurs, professional men, and farmers. From the executive he wants more detail, especially in regard to expense accounts.¹⁴ He would require employers to report separately all payments, in cash, kind, or use of certain facilities, made to top executives and shareholders, whether or not the payments constitute gross income to the recipient. The Revenue Service would then be able to decide the latter point for itself.¹⁵ For farmers, entrepreneurs, and professional men he would require balance sheet reporting for those with non-investment, non-salary income in excess of fifteen or twenty thousand dollars. This requirement would be extended down the income scale as details were worked out.¹⁶

It has been estimated that three billion dollars of interest and dividends — principally the former — is now unreported¹⁷ and both men desire withholding of tax on interest and dividends as a remedy.¹⁸ A specific method has been suggested by Mr. Surrey: the debtor or corporation would withhold a flat percentage, equal to the rate of the first bracket, without allowance for exemptions. The recipient would then add the amount withheld to the amount received in reporting his income and receive a credit for the amount withheld. No individual withholding forms would be filed with the government by debtors or corporations. The method would insure at least some payment of the tax on all dividends and interest, and insure perfect compliance in the first bracket.¹⁹

Both officials urge more efficient auditing.²⁰ Mr. Surrey suggests that committees of the American Bar Association Section on

¹³ N.Y. Times, April 21, 1961, p. 19, col. 3 (city ed.).

¹⁴ Surrey, *supra* note 12, at 827.

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ N.Y. Times, April 21, 1961, p. 18, col. 7 (city ed.). The President states that the effort to remedy the situation by education has failed. *Ibid.*

¹⁸ Caplin, *supra* note 2, at 852; Surrey, *supra* note 12, at 827.

¹⁹ Surrey, *supra* note 12, at 827 n.41.

²⁰ Caplin, *supra* note 2, at 852-53; Surrey, *supra* note 12, at 828.

Taxation and of the American Institute of Certified Public Accountants be appointed to study the auditing procedure and suggest methods for making it more effective.²¹ He has also made his own detailed suggestions for improving the auditing process:²²

1. Agents should be less susceptible to obvious errors left as "bait" to draw attention from substantial questionable items.
2. Agents should make more thorough pursuit of obvious leads to information such as long-term reports on certified audits showing reserves for taxes, corporate minutes, and year-end accounting adjustments, which sometimes indicate questionable accounting practices.
3. Agents should become acquainted in detail with taxpayers' accounting systems by such methods as tracing vouchers through the system and scanning inventory account sheets for distortions in pricing methods.
4. Agents should check in detail the cost-of-goods-sold accounts and include a scanning of a list of vendors to taxpayer to turn up items purchased as fringe benefits for employees.
5. Agents should not be guided in their audits solely by the classifications of items required by the tax return.

IV. PROPOSED SUBSTANTIVE CHANGES

The new officials have specifically designated a number of substantive provisions which they consider to be undesirable tax shelters. They have proposed legislative revisions of most of these provisions, and it is to be expected that the litigation and administrative processes will also be used to develop the law whenever practicable. Perhaps the most significant area of attack at the legislative level is on the present treatment and definition of capital gain.

A. *The Capital Gains Provisions*

Both men urge revision of the capital gains provisions. Mr. Surrey has for some time continued a sweeping attack on the treatment of capital gain. First, he feels there is nothing in the nature of a capital gain which requires its separate treatment purely for

²¹ Surrey, *supra* note 12, at 828.

²² Surrey, quoted in *Methods of Improving Audits Performed by IRS Agents Discussed*, 8 J. TAXATION 109 (1958).

reasons of equity.²³ Second, he believes capital gain cannot satisfactorily be defined and that congressional and judicial attempts to do so cause one of the major complexities in our income tax law.²⁴ Third, he believes the separate treatment of capital gain provides an easy and undesirable way by which Congress can create tax shelters for pressure groups by giving a non-investment transaction capital gains treatment in lieu of an out-and-out lower rate or averaging device.²⁵

1. *Proposed Changes in Capital Gains Taxation.* While both officials have made specific suggestions in the capital gains area, Mr. Surrey's proposals are the more detailed. First, he would solve the definitional problem primarily by making capital gain treatment less desirable, thus easing the pressure on the definition.²⁶ He would also narrow the general definition to include, insofar as possible, only purely investment activities, but he has not been specific about this change in the general definition.²⁷

Second, he would raise the required holding period to three years, with perhaps a decreasing rate scaled to the length of the holding period in excess of this minimum.²⁸

Third, Mr. Surrey would raise the maximum capital gain rate to approximately forty-five percent and eliminate the deduction for one-half of long-term capital gain. As an alternative, he would consider applying the ordinary income rates coupled with a deduction of one-fourth to one-third of long-term capital gain. These are mutually exclusive proposals; Mr. Surrey apparently does not favor enacting both and giving the taxpayer a choice between the two methods. The first proposal is the one he emphasizes.²⁹

Fourth, he would increase the capital loss allowance, but he has not been specific as to the size of the increase.³⁰

Fifth, he would attempt to eliminate the tendency of a capital gains tax to deter transfers of appreciated assets — commonly called the lock-in effect — by (1) taxing unrealized capital gains at death

²³ Surrey, in *Federal Tax Policy for Economic Growth and Stability, Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report*, 84th Cong., 1st Sess., vol. 1, at 320 (1955) [hereinafter cited *1955 Hearings*].

²⁴ See generally Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956).

²⁵ Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 819-20 (1958).

²⁶ Surrey, *supra* note 24, at 1016, 1019; Surrey, *supra* note 25, at 819.

²⁷ Surrey, *supra* note 25, at 820; *1955 Hearings* 327.

²⁸ Surrey, *supra* note 24, at 1016.

²⁹ Surrey, *supra* note 24, at 1016; *1955 Hearings* 314, 344.

³⁰ Surrey, *supra* note 24, at 1016; Surrey, *supra* note 25, at 830.

or gift, or (2) carrying over to the transferee the decedent's basis in a capital asset transferred at death. The method he emphasizes is taxing unrealized capital gains at death or gift.³¹

Sixth, the new Assistant Secretary would permit "averaging" of capital gains by spreading them over the year of receipt and the two previous years.³²

Seventh, he would tighten provisions on corporate reorganizations and distributions. He has not been specific about the nature of this "tightening."³³

Eighth, he would eliminate completely capital gain treatment of a number of transactions which he believes do not involve sale of investment assets, but which he believes were afforded capital gain treatment as the result of astute lobbying and in lieu of lower rates or averaging. Included are executive stock options, lump-sum termination of interests in pension trusts, sales of patents and patent royalties, sales of coal, oil, and timber royalties, sales of growing crops and breeding livestock, sales of real property and depreciable assets used in a trade or business, and the notorious Mayer³⁴ provision.³⁵

In his comments on capital gains provisions, Mr. Caplin has cited the articles of then-Professor Surrey. However, his proposals, which are less numerous, differ in some details. Notable differences are that he mentions increasing the holding period to "at least one year," and proposes only one method for treating capital assets at death — carrying forward to the legatee the basis of the decedent. Upon sale of depreciable assets, he would deny capital gain treatment except to the extent the sale price exceeded the original cost. With regard to the capital gain rate structure, he proposes to eliminate the twenty-five percent alternate tax and to force all taxpayers to use the fifty percent deduction. However, he, too, doubts the desirability of separate treatment of capital gain in the first place.³⁶

2. *Mr. Surrey's Views on the Desirability of Separate Taxation of Capital Gain.* Mr. Surrey has published his views upon

³¹ Surrey, *supra* note 24, at 1018 n.95.

³² Surrey, *supra* note 24, at 1016.

³³ *Ibid.*

³⁴ INT. REV. CODE OF 1954 § 1240. It is generally assumed that at the time of its enactment the provision was applicable only to Louis B. Mayer and one other executive of Loew's, Inc. Surrey, *supra* note 4, at 1147 n.4.

³⁵ Surrey, *supra* note 24, at 1016; Surrey, *supra* note 25, at 819, 822; 1955 *Hearings* 314.

³⁶ Caplin, *supra* note 2, at 846.

five of the arguments often heard in the theoretical controversy which rages over the issue of separate tax treatment of capital gain. These are (1) an income tax should "tax the fruit but not the tree"; (2) a capital gains tax has a harmful "lock-in" effect; (3) a separate low rate on capital gains acts as a desirable stimulus to saving and investment in the economy as a whole; (4) a capital gains tax has the effect of a capital levy during a period of inflation; and (5) capital gains are generally realized "in a lump," and a low rate is therefore needed in lieu of an averaging device.³⁷

On the question of taxing the "tree" differently from the "fruit," Mr. Surrey says, "I start with the viewpoint that these capital gains are dollars received by people and are like any other dollars. On equity grounds they therefore should be taxed the same as any other dollars."³⁸ Walter Heller, Chairman of the President's Council of Economic Advisers, agrees with Mr. Surrey on this point.³⁹ There are, of course, those who strongly disagree.⁴⁰

Mr. Surrey feels that under the present rate structure the lock-in effect is not serious. He bases this opinion primarily upon arguments of Mr. Heller.⁴¹ Mr. Heller's view, as expressed before Congress, is that the severity of the lock-in effect under the present rate structure has been greatly overrated. Mr. Heller bases his opinion on three grounds. First, he feels that many market transactions are outside the deterrent effect of the capital gains tax because made by tax exempt organizations or made for compelling reasons which require that the tax be ignored.⁴² Second, he believes that in a dynamic market the change in values necessary to compensate for the effect of a tax at transfer is relatively small. For example, he states that "stockholders who accurately gaged the pulse of the market" could easily more than compensate themselves for the effect of the tax by proper trading in thirty major stocks during 1955.⁴³ However, he admits the lock-in effect may

³⁷ For views generally opposed to those of Mr. Surrey on the capital gain question, see Dan Throop Smith, *Tax Treatment of Capital Gains*, in 2 HOUSE COMM. ON WAYS & MEANS, TAX REVISION COMPENDIUM 1233 (1959) [hereinafter cited 1959 COMPENDIUM]; Brown, 1955 Hearings 307; Magill, *Federal Income Tax Revision*, in 1959 COMPENDIUM 87.

³⁸ 1955 Hearings 320.

³⁹ 1955 Hearings 310, 318.

⁴⁰ See note 37 *supra*.

⁴¹ Surrey, *supra* note 24, at 1018 n.95.

⁴² Heller, *Investors' Decisions, Equity, and the Capital Gains Tax*, in JOINT COMM. ON THE ECONOMIC REPORT, FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 381, 385-86 (1955).

⁴³ *Id.* at 384-85.

not be dismissed as insignificant upon this ground alone because the investor must trade a certain tax for an uncertain market change and because the tax may have a psychological effect unrelated to mathematics.⁴⁴

Mr. Heller's third ground for doubting the severity of the lock-in effect is a study of the impact of taxes upon the decisions of 746 investors made under the auspices of the Harvard Business School. When asked whether federal taxes affected their investments only ten percent of the upper bracket investors in the group studied volunteered answers indicating that the long term capital gains tax affected the timing of a shift in their investments.⁴⁵ The two questions asked of the group were very general in nature and were directed primarily at ascertaining the tax effects upon the investment capacity of the individuals and the types of investments which they selected.⁴⁶ The authors of the study state that the nature of the questions probably resulted in significantly fewer answers directed to the lock-in effect than would have been the case if the questions had been aimed more specifically at that consideration.⁴⁷ The 746 individuals studied were selected from persons in various cities whose names were contained in the customer files of stockbrokers. The authors of the study admit the possibility of the inclusion of a disproportionate number of active traders but say this is unlikely because at the wealth levels within which the study was primarily made most persons own stock and even those who do not are likely to be on brokers' customer lists.⁴⁸

Mr. Surrey believes the lock-in effect would become harmful if the capital gain rate were raised and the other Code provisions, including ordinary income rates, remained the same.⁴⁹ This view is shared by several economists, including Mr. Heller.⁵⁰ Mr. Surrey, again with Mr. Heller concurring,⁵¹ would solve this problem by taxing unrealized capital gains upon transfers of property at death or by gift, with a carry-over basis as an alternative legislative proposal.⁵² The first method would cause serious liquidity problems

⁴⁴ *Id.* at 386.

⁴⁵ *Id.* at 384. The study upon which Mr. Heller relies is BUTTERS, THOMPSON & BOLLINGER, *EFFECTS OF TAXATION [ON] INVESTMENT BY INDIVIDUALS* (1953).

⁴⁶ BUTTERS, THOMPSON & BOLLINGER, *op. cit. supra* note 45, at 45, 513.

⁴⁷ *Id.* at 45, 340, 341, 348, 513.

⁴⁸ *Id.* at 12, 348, 452, 456.

⁴⁹ Surrey, *supra* note 24, at 1018 n.95.

⁵⁰ See the view of Heller, Carl Shoup, and J. Keith Butters, in 1955 *Hearings* 310, 311, 314.

⁵¹ 1955 *Hearings* 310.

⁵² Surrey, *supra* note 24, at 1018 n.95.

for a substantial percentage of estates,⁵³ and particularly of small estates. The extreme nature of the problem where decedent owned a non-liquid family business is obvious. The Surrey solution could not be completely effective to the extent that investors, being human, will delay a transaction which causes a tax to be levied immediately although the tax appears to be inevitable. In addition, the investor will receive the income from the funds which would pay the tax, so long as he delays the transaction. The difficulties involved in solution of the lock-in problem, among other things, have led a number of authors to propose a "rollover" provision for capital assets, whereby gain would not be recognized and basis would be carried over if the funds received from sale of a capital asset were reinvested within a certain time. Gain not properly reinvested would be taxed.⁵⁴ In this context and in the context of the averaging problem, Mr. Surrey stated that he believes nothing in the Constitution prevents Congress from taxing each year the increase in value of an asset, whether or not the increase has been realized.⁵⁵ He has suggested no such legislation. The administrative problems are obvious. He has proposed an averaging provision for capital gains.

A substantial number of economists feel that the lower rate on capital gain has made possible an adequate amount of savings and investment despite extremely high rates on the ordinary income of those taxpayers who do the significant saving and investing.⁵⁶ It is only in deference to this view that Mr. Surrey would retain any separate rate treatment of capital gain.⁵⁷ He does not believe that his proposed maximum rate of approximately forty-five percent, coupled with lower ordinary income rates, increased allowance for capital losses, and full taxation of the interest from state and municipal bonds would have any harmful effect on the economy.⁵⁸ His views are supported by some economists.⁵⁹ There are,

⁵³ If unrealized gains were constructively realized at death in those estates now taxed under the estate tax, the total taxes to be paid at death would be increased—in the aggregate—by 40%. The percentage increase would be greatest for smaller estates. Steger, *Economic Consequences of Substantial Changes in the Method of Taxing Capital Gains and Losses*, in 2 1959 COMPENDIUM 1261, 1280 (1959).

⁵⁴ See, e.g., Dan Throop Smith, *supra* note 37; Clark, *The Paradox of Capital Gains: Taxable Income That Ought Not To Be Currently Taxed*, in 2 1959 COMPENDIUM 1243, 1247; Miller, *Taxation of Capital Gains*, in 2 1959 COMPENDIUM 1257; Silverstein, *The Capital Asset Definition*, in 2 1959 COMPENDIUM 1285, 1295.

⁵⁵ 1955 Hearings 323.

⁵⁶ See the following opinions: Heller, Shoup and Butters in 1955 Hearings, 310, 311, 314; Paul McCracken, in 1955 Hearings 97; Dan Throop Smith, *supra* note 37.

⁵⁷ 1955 Hearings 320.

⁵⁸ 1955 Hearings 344.

of course, those who believe any increase in the capital gain rate would be harmful,⁶⁰ and perhaps those who believe capital gain could be treated as ordinary income with no ill effects.⁶¹

After any period of inflation, especially one of the nature and duration experienced by the United States in the past twenty years, a portion of most realized capital gains will be illusory. From time to time proposals are advanced which are designed to take closer account of this fact in taxing capital gain.⁶² The administrative difficulties would be formidable. Moreover, there are those who believe a capital gains tax on the illusory value has a desirable counter-cyclical economic effect.⁶³ It is arguable that any separate and lower rate on capital gains, including the present separate rate structure, does some measure of rough justice in an inflationary period.⁶⁴ Mr. Surrey's proposed maximum rate of forty-five percent would give no relief from ordinary income rates to the small investor whose rate is already beneath forty-five percent. It is, of course, impossible to determine to what extent such small investors who have held property since the early forties view the present treatment of capital gain as a rough allowance for inflated property values. To the extent that they do so, they will presumably be strongly opposed to Mr. Surrey's proposal to take away the "allowance."

Mr. Surrey himself does not believe the income tax, including the capital gains tax, should take inflation into account. Furthermore, he believes it to be equitable to put an additional tax bite on the investor who has a hedge against inflation, because those on a fixed income have no hedge. He goes on to say that we will be lost in the wilderness if we try to separate illusory gain from real gain, a position widely held.⁶⁵ However, his statement that we should tax the investor upon illusory gains because some people have no illusory gains is open to criticism. There seems to be no more equity in trying to put the investor who shifts investments

⁵⁹ See the following opinions: Heller, Shoup, and Butters, in *1955 Hearings* 310, 311, 314.

⁶⁰ Brown, in *1955 Hearings* 307; Dan Throop Smith, *supra* note 37; Magill, *supra* note 37; cf. McCracken, in *1955 Hearings* 97.

⁶¹ Cf. Groves, *Taxation of Capital Gains*, in 2 *1959 COMPENDIUM* 1193.

⁶² See, e.g., Corbin, *New Proposals for Capital Gains Taxation*, 34 *TAXES* 663, 668 (1956); Uhr, *Implications of "New Proposals for Capital Gains Taxation,"* 35 *TAXES* 267 (1957).

⁶³ See, e.g., Heller, in *1955 Hearings* 328, 347.

⁶⁴ Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *TAXES* 247, 255 (1957).

⁶⁵ *1955 Hearings* 330.

in the position of the recipient of a fixed income than in trying to put such an investor in the position of the wage earner, who suffers only one additional tax as a result of inflation and thus is better off than the investor for the following reasons. The wage earner has been on the whole quite able to maintain his relative income position during the period of inflation since World War II.⁶⁶ As the wage earner's income rises during inflation he pays more income tax. During a period of inflation, *ceteris paribus*, the investor's income from his property will rise and he will also pay more income tax. The value of his property will rise to reflect its increased production of income. If the investor changes the form of his property he realizes the inflationary gain, pays a capital gains tax, and is left with fewer dollars to invest. After reinvestment he will have fewer dollars of disposable income than before, and thus is hurt more than the wage earner, who is not forced to capitalize his earning power and pay a tax on its increase when he changes jobs.

3. *Mr. Surrey's Views on the Definition of Capital Gain.* Mr. Surrey's criticisms of the nature and complexities of the statutory definition of capital gains are lengthy and effective. His views are necessarily affected by the fact that he does not believe separate taxation of capital gain is desirable in the first place. In another narrower area, that of multiple trusts, he is willing to wrestle with an extremely difficult definition when he believes that definition to be necessary for equitable taxation.⁶⁷ In the capital gains area he apparently concludes that a truly satisfactory definition of capital gain is impossible, and that the best to be hoped for is an uneasy truce between taxpayer and government.⁶⁸ Mr. Heller is apparently not in complete accord on the non-availability of a satisfactory working definition.⁶⁹

Mr. Surrey states that Congress, in defining capital gain, has attempted the difficult task of separating investment activities from business activities, speculation, and the rewards of personal effort⁷⁰ and that the difficulties of so doing are compounded by tax recognition of corporations and partnerships as separate entities for some purposes.⁷¹ In general, he feels most of the present defini-

⁶⁶ Bach, in 1955 *Hearings* 48, 54.

⁶⁷ See text accompanying note 120 *infra*.

⁶⁸ Surrey, in 1955 *Hearings* 324.

⁶⁹ Heller, in 1955 *Hearings* 345.

⁷⁰ Surrey, *supra* note 24, at 990, 999, 1001.

⁷¹ *Id.* at 1008-15.

tional provisions are too specific.⁷² The distinction between investment gain and business gain is now enforced primarily by the definition of capital assets. Mr. Surrey apparently believes this tool should be accompanied by further congressional distinctions among the causes of an increase in the value of property — for example, between rises attributable to taxpayers' individual efforts and those not so attributable.⁷³ Further, he criticizes the definition of a capital asset because of its broad inclusion — "property" — coupled with specific exclusions. He impliedly would favor the method of a broad exclusion with specific inclusions.⁷⁴

In the area of distinguishing speculation from investment, Mr. Surrey is highly critical of the present short holding period, and of the exclusive use of the holding period to separate speculators from investors.⁷⁵ He, of course, proposes a longer holding period, which would eliminate many problems in this area and in the business-investment distinction area as well. Mr. Surrey and Mr. Caplin both have repeatedly criticized the present capital gain treatment of the large-scale exchange speculator who holds for over six months.⁷⁶ Mr. Surrey discusses the fact that such activity has been held to be a trade or business, but that the assets were not found to be held for sale to customers.⁷⁷ In the same article he discusses the *Corn Products Refining Company* case,⁷⁸ where the Supreme Court found corn futures to be non-capital assets although not held for sale to customers in the ordinary sense of the phrase. Neither Mr. Surrey nor Mr. Caplin expressly suggests the following, but it is conceivable in view of their opposition to capital gain for professional speculators that they might try to tax such speculators' gains as ordinary income under the rationale of *Corn Products*.

Mr. Surrey's most telling examples of the difficulty of the capital gains definition are in the area where the separate treatment of the corporate entity complicates the problem. For example, he cites the problems of corporate liquidations, distributions, accumulation of income, and the transfer of appreciated non-capital

⁷² *Id.* at 1016.

⁷³ Surrey, *supra* note 24, at 988.

⁷⁴ *Ibid.*

⁷⁵ *Id.* at 999.

⁷⁶ Caplin, *supra* note 2, at 843; Surrey, *supra* note 24, at 1000; Surrey, *supra* note 25, at 819 n.21.

⁷⁷ Surrey, *supra* note 24, at 992, 1000.

⁷⁸ *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). Surrey, *supra* note 24, at 992.

assets into a corporate shell followed by sale of the stock.⁷⁹ Many of these problems would melt away if a feasible method could be devised and enacted to tax undistributed corporate profits directly to shareholders, but no such plan appears to be in the offing.

B. *The "Double Tax" on Corporate Profits*

1. *The Dividends Received Credit.* Both men favor elimination of the dividends received credit and exclusion.⁸⁰ Mr. Surrey is opposed to these provisions because they are not sufficiently geared to the amount of overtaxation suffered by the recipient of dividends and ordinarily, he feels, give greater proportionate relief from overtaxation to the high-bracket taxpayer.⁸¹ He does not seem particularly concerned about giving alternative relief, but does feel that if Congress decides to do so the English method for taking account of the corporate tax should be adopted. This method, in brief, is to add to dividends received the corporate tax paid thereon and include the total in the recipients' income; a credit of the amount of the corporate tax paid is then given to the taxpayer.⁸² However, there would be certain difficulties involved in the adoption of such a plan, such as numerous refunds and some windfalls to shareholders.⁸³ Mr. Surrey has not otherwise addressed himself specifically to the problems of double taxation and taxation of retained corporate profits, except as these problems affect the capital gain provisions. Neither he nor Mr. Caplin has mentioned in publication any plan for a reduction of corporate tax rates.

2. *A Solution of the "Double Taxation" Problem Proposed by Mr. Caplin.* Mr. Surrey, while he has not written specifically on the double taxation problem, recognizes the historical trend toward attempting to eliminate two taxes on the same income. Mr. Caplin, however, in a recent article, has advocated a somewhat startling approach—a large step in the other direction. He would divide all business enterprises into two groups. The first of these would have an extremely low limitation on the number of shareholders or members and on net worth. Enterprises in this

⁷⁹ Surrey, *supra* note 24, at 1008-15.

⁸⁰ Caplin, *supra* note 2, at 845. Surrey, *supra* note 25, at 820-21.

⁸¹ Surrey, *supra* note 25, at 820-21.

⁸² *Id.* at 821 n.25.

⁸³ Shoup, *The Dividend Exclusion and Credit in the Revenue Code of 1954*, 8 NAT'L TAX J. 136, 145 (1955); Dan Throop Smith, *Two Years of Republican Tax Policy: An Economic Appraisal*, 8 NAT'L TAX J. 2, 9 (1955).

group would be taxed generally as partnerships are now taxed. The second group would consist of all other business enterprises, whether now designated corporations, partnerships, associations, trusts, proprietorships, or what-have-you. Enterprises in the second group would be taxed on their taxable income on a schedule of sharply progressive rates beginning at ten percent and rising as high as revenue needs require. Owners of such enterprises would include in their incomes the distributions of the enterprises, in accord with earnings and profits principles now applied to corporations.⁸⁴

Mr. Caplin offers such a scheme as a solution to the complexities now arising from the numerous available taxable business entities and the differences between them: corporation, partnership, subchapter S, subchapter R, association, proprietorship, trust.⁸⁵ His plan would itself create substantial complexities, however. If his scheme were enacted it would still be necessary to categorize items of income according to their source. Obviously he would want to distinguish personal effort income—salaries and wages—from business enterprise income, for the latter would be taxed twice if distributed. Since these two categories do not neatly cover all types of income, presumably there would have to be a third category for “non-enterprise income” which would arise neither from personal efforts nor from an enterprise. The necessary existence of this third category covering such items as interest, rents, and royalties would continue tax discrimination among items of income not attributable solely to personal efforts. For example, if a coal royalty were not enterprise income, would there not still be discrimination between the royalty holder and the owner of the mining operation, which would pay an enterprise tax? Is the existence of an “enterprise” sufficient or desirable reason for such discrimination?

The use of a business enterprise concept would require a broader use of the difficult distinction between income from a business enterprise and income from a non-enterprise. The distinction would presumably be somewhat similar to those now used in defining a “trade or business” for capital gains⁸⁶ and section 162

⁸⁴ Caplin, *Income Tax Pressures on the Form of Business Organization: Is It Time for a “Doing Business” Tax?* 47 VA. L. REV. 249, 260 (1961).

⁸⁵ *Id.* at 261.

⁸⁶ INT. REV. CODE OF 1954, § 1221.

purposes,⁸⁷ and an "association" for corporate taxation purposes.⁸⁸ The distinction in the case of the coal royalty and the coal mining operation is fairly clear, but the in-between cases would be harder. Further, what should be done about businesses performing services for customers? For instance, would an individual stock broker, commission broker, realtor, or lawyer be engaged in an enterprise? If not, would a large brokers' partnership, or a large law firm, or a large real estate dealers' partnership?

The distinction between personal effort income and enterprise income would also be difficult. The problem, of course, is now faced to a limited degree in the context of the closely-held corporation when an officer-shareholder receives an excessive "salary." Mr. Caplin's plan would require an extension of the distinction to most large partnerships and associations. If the enterprise classification included large areas of economic activity now organized in partnership form, there would be few "yardsticks" with which a partner's income could be measured to determine how much was properly salary and how much properly enterprise income. For instance, how would one determine what portion of a senior law partner's income is properly attributable to his personal efforts?

To begin treating a large number of enterprises as corporations are now treated would considerably increase the number of taxpayers who must wrestle with all the problems of corporate distribution, including earnings and profits, mergers, redemptions, liquidations, and sales of shares.⁸⁹ Furthermore, a progressive rate and the exemption of small enterprises would greatly increase the advantage of multiple entities, thus enormously expanding the pressures and complexities surrounding those sections dealing with multiple entities—269, 482, 1501, 1551 and the like.⁹⁰

The complexities which Mr. Caplin seeks to eliminate are indeed severe, but they have for the most part been dealt with for some time by the tax bar, the revenue service, the courts, Congress, and the taxpaying public. The process of education in their intricacies is to some degree accomplished. Mr. Caplin's proposal would require substantial re-education in new complexities.

Finally, it is not clear to what extent the present corporate tax is a regressive tax passed on to the consumer or to the wage earner.

⁸⁷ INT. REV. CODE OF 1954, § 162.

⁸⁸ INT. REV. CODE OF 1954, § 7701.

⁸⁹ INT. REV. CODE OF 1954, §§ 301-82.

⁹⁰ INT. REV. CODE OF 1954, §§ 269, 482, 1501, 1551.

Many feel that a substantial part of it is so passed on.⁹¹ If Mr. Caplin's proposed tax were passed on it would affect more consumers than the present corporate tax, which reaches only purchasers from corporations. On the other hand, the progressive nature of the proposed tax would prevent large enterprises from passing to the consumer as great a proportion of the tax as their smaller competitors could. Although this might take some tax burden off the consumer, it would endanger the competitive position and the after-tax profit margin of large enterprises. Furthermore, a progressive tax appears unsuited to business enterprises because it cannot take into account the varying sizes of the incomes of the shareholders in a multi-shareholder enterprise.

*C. Mr. Caplin's Opinions on Certain Narrower
Corporate Taxation Issues*

Mr. Caplin has addressed himself to several other problems in the corporate area, including subchapter S, the thin-incorporation doctrine, certain of the problems in the spin-off area, and subchapter R. Basically he believes the fiction of the separate corporate entity to be one of the cornerstones of our tax law and not lightly to be disregarded.⁹² He is opposed, however, to creation of new types of taxable entities.⁹³ On this latter ground he has strongly attacked subchapter S, urging that it either be repealed *in toto* or amended to conform as precisely as possible to the provisions for taxing partnerships. If the latter approach is taken, he has made ten recommendations to the legislators,⁹⁴ all generally intended to bring subchapter S treatment closer to partnership treatment:

1. Limit election to new corporations, and make the earnings and profits account, if still used, coincide exactly with taxable income. Such treatment is proposed in order to eliminate the problems now encountered in handling pre-election earnings and profits.
2. Put a dollar limit on net worth and eliminate the restrictions on personal holding company income.

⁹¹ Darling, *Income Taxation and Dividend Income*, in 3 1959 COMPENDIUM 1579, 1580.

⁹² Caplin, *supra* note 7, at 54.

⁹³ Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 VA. L. REV. 61, 80 (1960).

⁹⁴ *Ibid.*

3. Limit the events causing termination of the election to increase flexibility of the subchapter S device in some situations and minimize avoidance in others.
4. Curtail severely the right to renew the election to minimize avoidance.
5. Treat the fiscal year problem as it is treated in the partnership provisions, again to eliminate possibilities of avoidance.
6. Allocate taxable income for any part of a year to the shareholdings as they were during that part of the year to prevent shifting of accrued income.
7. Do not allow shareholders to be deemed employees except in limited cases.
8. Allow distributions in kind to be made in the same manner as distributions in cash.
9. Preserve the non-dividend status of previously-taxed income despite termination of the election or sale of stock. Allow more latitude generally in withdrawals.
10. Treat net operating loss as it is treated in the partnership provisions—allow the excess over basis to be taken whenever a basis is restored.

In the context of the thin-incorporation doctrine, Mr. Caplin believes the courts have gone too far in preferring substance over form. He believes the statute says "interest" and "dividends," and clear debt instruments should not be denied debt status absent evidence of intent not to have a debtor-creditor relationship.⁹⁵ In the application of section 355, Mr. Caplin has urged a liberal construction of the five-year active business requirement, with the government's main protection against avoidance transactions being the "device" terminology of section 355 (a) (1) (B).⁹⁶ Both Mr. Surrey and Mr. Caplin have spoken disparagingly of section 1361, which permits a narrowly-limited class of partnerships to elect to be taxed as corporations.⁹⁷

D. *The Depletion Allowances*

The depletion allowances have long been a target of tax reformers and Messrs. Surrey and Caplin are among the attackers.

⁹⁵ Caplin, *supra* note 7, at 61.

⁹⁶ Caplin, *The Five-Year Business Rule for Corporate Separations*, 35 TAXES 381, 390 (1957).

⁹⁷ Caplin, *supra* note 84, at 261; Surrey, *supra* note 4, at 1147 n.4 (i).

Mr. Surrey refers to the allowances as an unwarranted tax preference deserving serious congressional study.⁹⁸ Mr. Caplin has been more specific; he would lower all percentage rates and allow the new percentages only until capitalized costs were recovered.⁹⁹ The rate reduction advocated by the two men¹⁰⁰ would mitigate to some degree the effect of the loss of the depletion allowance.¹⁰¹ However, to the extent that the loss of the depletion allowance did not result in a rise in retail mineral prices, it would cause the price of mineral property to fall in relation to the price of other property, and this would indeed hurt the individual holders of mineral properties. The question of the extent to which mineral retail prices would rise leads to the consideration of the corporate position in the depletion picture.

A substantial majority of the depletion dollars go to large corporations.¹⁰² No decrease in the tax rate for these corporations has been proposed, and the loss of the depletion allowance would bite deeply here. The bite would pass on to humans in one of two directions: to the consumer in the form of higher prices on petroleum products and by-products and to the stockholder in the form of lower dividends. To the extent that the depletion allowance has heretofore been reflected in lower mineral prices to consumers, there would seem to be no injustice in shifting the burden of the allowance from the government to the consumer. But one can have more sympathy for injury suffered in the form of lower dividends and stock prices by one who purchased shares in an oil company at a price which discounted the existence of the depletion allowance.

E. *The Exemption of State and Municipal Bond Interest*

Mr. Surrey calls the exemption of interest on state and local bonds indefensible in terms of income tax policy. It is, he says, an undesirable solution of federal-state relationships with the wealthy an undeserving third-party beneficiary. He favors full taxation of the interest and believes the constitutionality of such a tax no longer debatable.¹⁰³

⁹⁸ Surrey, *supra* note 25, 819.

⁹⁹ Caplin, *supra* note 2, at 849.

¹⁰⁰ While the two officials speak generally of a 25% reduction in rates, they also speak of lowering the maximum rate to 65%, which is slightly more than a 25% reduction.

¹⁰¹ INT. REV. CODE OF 1954, § 613 (b).

¹⁰² Gray, in 1955 *Hearings* 351; Stanley, in 1955 *Hearings* 384.

¹⁰³ Surrey, *supra* note 25, at 817, 818.

F. *The Personal Deductions*

1. *The Deduction for Charitable Contributions.* Nearly all of the personal deductions are under fire by both men. A major emphasis is placed on the deduction for charitable contributions. Mr. Caplin recommends that the deduction in all cases be limited to the lower of fair market value or basis. He favors such a provision as a method of eliminating a number of avoidance schemes and solving as well the problem of gifts of section 306 stock to charities.¹⁰⁴ Mr. Surrey takes a slightly different tack. He recommends inclusion in the taxpayer's income of the difference between basis and fair market value, especially if the appreciation not realized would have been ordinary income to the donor. If the income not realized would have been capital gain, he is willing to make an exception if the pressure for such an exception is strong.¹⁰⁵ In 1956 he recommended such a statutory change, but significantly wondered aloud why the Treasury had not, in all cases, attempted to tax the appreciation in value to the donor under the case law of section 61.¹⁰⁶ He cited *Austin v. Commissioner*¹⁰⁷ and *Anthony's Estate v. Commissioner*.¹⁰⁸ In addition, *Helvering v. Horst*,¹⁰⁹ *Commissioner v. First State Bank of Stratford*,¹¹⁰ and *United States v. General Shoe Corp.*¹¹¹ would seem to be applicable. Mr. Surrey also urges a denial of deductions for all expenses incurred in building up the value of an asset donated to charity.¹¹² Both gentlemen believe the family charitable foundation deserves scrutiny.¹¹³

2. *The Interest Deduction.* Mr. Caplin urges denial of the interest deduction on all loans made to purchase life insurance.¹¹⁴ Mr. Surrey goes farther. He urges first that a maximum be put

¹⁰⁴ Caplin, *supra* note 2, at 849.

¹⁰⁵ Surrey, *Memorandum Regarding Certain Items in the List of Substantive Unintended Benefits, Hearings on Technical Amendments to the IRC Before a Subcommittee of the House Ways and Means Committee*, 84th Cong., 2d Sess., vol. 5, at 436 (1956).

¹⁰⁶ *Ibid.* After losing on two attempts to tax as income to the donor the appreciation in the value of farm products donated to charity, the Commissioner in 1955 issued a ruling that such appreciation would not be taxed to the donor. *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954); *White v. Broderick*, 104 F. Supp. 213 (D. Kan. 1952); REV. RUL. 55-138, 1955-1 CUM. BULL. 223.

¹⁰⁷ 161 F.2d 666 (6th Cir. 1947).

¹⁰⁸ 155 F.2d 980 (10th Cir. 1946).

¹⁰⁹ 311 U.S. 112 (1940).

¹¹⁰ 168 F.2d 1004 (5th Cir. 1948).

¹¹¹ 282 F.2d 9 (6th Cir. 1960).

¹¹² Surrey, *supra* note 105, at 436.

¹¹³ Caplin, *supra* note 2, at 849; Surrey, *supra* note 25, at 826.

¹¹⁴ Caplin, *supra* note 2, at 851.

on the amount of the deduction. Second, he urges a broadening of sections 264 (a) (2) and 265 (2) plus the enactment and vigorous enforcement of a broad *in terrorem* provision denying the deduction whenever a transaction lacks business reality. The transaction would be deemed to lack business reality whenever its prime end was only the deduction plus a sale at capital gain rates, a gift to charity, or the like.¹¹⁵

3. *The Deductions for State and Local Taxes, Medical Expenses and Casualty Losses.* Mr. Surrey favors retention of the deduction for state income taxes, elimination of the deduction for state excise taxes, and a maximum limit on the deduction for state property taxes.¹¹⁶ He sees the latter deduction as an unjustified subsidy to home owners and mortgagors.¹¹⁷ Defenders of states rights would object to Mr. Surrey's foregoing proposals on the ground that if the federal government is to make an allowance for the revenue needs of the states, it should not discriminate in favor of citizens of states raising the major portion of their revenue by an income tax and against citizens of those raising the major portion of their revenue by excise or property taxes. Arguably, dictating the revenue-raising methods of the states is not the proper concern of the federal government.

Mr. Surrey would raise the present "three percent of adjusted gross" limitation on the medical deduction to five percent and institute a similar limitation on deductions for casualty losses.¹¹⁸ Along with the restrictions on the personal deductions, he favors a lowering of the ten percent standard deduction to three or four percent.¹¹⁹

G. *Miscellaneous Areas of Avoidance: Multiple Trusts,
Life Insurance, Sales of Life Interests,
Deferred Compensation*

1. *Multiple Trusts.* In response to congressional committees, Mr. Surrey has addressed himself to several less significant areas where he believes unjustified tax avoidance occurs. Included are multiple trusts, life insurance, sale of life interests, and deferred compensation plans. In the multiple trust area he sees three prime

¹¹⁵ Surrey, *supra* note 25, at 826; Surrey, *supra* note 105, at 437.

¹¹⁶ Surrey, *supra* note 25, at 826, 827.

¹¹⁷ *Ibid.*

¹¹⁸ *Id.* at 825, 826.

¹¹⁹ *Id.* at 826. Mr. Surrey says 3 or 4% of gross income, but he must mean adjusted gross income.

avoidance patterns: (1) the use of a large number of accumulation trusts with a common beneficiary; (2) the transfer of undivided interests in an appreciated asset whose sale will produce ordinary income, to multiple trusts prior to sale, investment of proceeds, and accumulation of income; and (3) the use of multiple trusts each distributing at intervals of six or more years to avoid the five-year throwback rule.¹²⁰

He proposes a threefold attack. First, he would either completely eliminate the exception to the throwback rule for termination of trusts in existence over nine years; or he would modify the exception to require that the trust have been in existence beyond the lives of beneficiaries living when the trust was created. Second, he would allow the benefit of only one of each of the following provisions to a beneficiary of more than one trust: the \$2,000 floor on the throwback rule, the limitation of the throwback rule to five years, and the exception to the throwback rule for accumulations during minority. Third, in addition to, and possibly as a substitute for, the second attack, he would require combination of multiple trusts into one trust for tax purposes. Trusts would be combined where each trust accumulates income for the same beneficiary or group of beneficiaries.¹²¹ He favors a broad general rule, supported by regulations and applied case by case, as a standard for requiring combination.¹²² He has given a suggestion of what should be included in such a rule:

"Thus, trust income could be regarded as being accumulated for a beneficiary if in the normal operation of the trust, under the happening of events reasonably to be expected *or which are anticipated in the trust instrument*, it is a reasonable conclusion that the accumulated income will either be distributed to that beneficiary or its disposition will become subject to his control. A class of beneficiaries could be treated as a single beneficiary if the interests of the class in the trust make that treatment appropriate."¹²³

It is not entirely clear under the above standard whether combination would be required merely because a disposition to certain beneficiaries upon happening of a very unlikely event had been expressly anticipated in the trust. It is doubtful that combination should be required in such a case. Mr. Surrey recognizes the

¹²⁰ Surrey, *supra* note 105, at 439.

¹²¹ *Id.* at 439.

¹²² *Id.* at 440.

¹²³ *Ibid.* (Emphasis added.)

difficulty of administering a rule such as he suggests, but he feels the result here justifies the complexity—in noticeable contrast to his feeling that the result did not justify the complexity in the capital gains area. It seems quite likely that the enactment of such a forced-combination provision would result in a proliferation of often-muddy case law similar to that which sprang up around the *Clifford* doctrine¹²⁴ prior to its codification. However, if it is desirable to attack the multiple trust problem, it might be best from a legislative standpoint to commence the attack with a broad provision, such as Mr. Surrey suggests, and clarify with codification only after the various problems and patterns had been thoroughly learned during development of the case law. Mr. Surrey is opposed to making proof that the multiplicity has as its prime purpose the avoidance of taxes a requirement for combination. He feels the simple existence of two trusts with one beneficiary is sufficient reason for combination. He would not make allowances for the situation, for example, where because of quirks of local law the estate planner sets up both an inter vivos and a testamentary trust for the same beneficiaries.¹²⁵

2. *Life Insurance.* The failure to tax interest earned upon life insurance premiums during the lifetime of the insured is regarded by both officials as undesirable.¹²⁶ Neither has proposed a change in the law, however, and Mr. Surrey regards such a change as politically unfeasible.¹²⁷ Although this comment does not deal generally with the estate tax, it is worthy of note that important changes are proposed in the life insurance area. Mr. Caplin impliedly would favor restoration of the payment of premiums as a test for inclusion of life insurance in the gross estate;¹²⁸ Mr. Surrey has expressly proposed its restoration.¹²⁹ Mr. Surrey has made further proposals in order to equate the treatment of life insurance with annuities and accumulation trusts. He would repeal section 2037 (a) (2)¹³⁰ and thus include in the gross estate any property the enjoyment of which could be obtained only by surviving decedent. A similar change would be made in section

¹²⁴ *Helvering v. Clifford*, 309 U.S. 331 (1940). For comments on the ensuing case law, see *Stockstrom v. Commissioner*, 148 F.2d 491, 496 (8th Cir. 1945); *Suhr v. Commissioner*, 126 F.2d 283, 288 (6th Cir. 1942).

¹²⁵ Surrey, *supra* note 105, at 441.

¹²⁶ Caplin, *supra* note 2, at 851, 852; Surrey, *supra* note 25, at 821.

¹²⁷ Surrey, *supra* note 25, at 821.

¹²⁸ Caplin, *supra* note 2, at 851, 852.

¹²⁹ Surrey, *supra* note 105, at 438.

¹³⁰ INT. REV. CODE OF 1954, § 2037 (a) (2).

2039 (a)¹³¹ in order to tax any annuity obtainable only by surviving the decedent. Finally, Mr. Surrey would repeal section 2039 (c),¹³² which now exempts from the estate tax annuities paid by qualified employee pension plans.¹³³

3. *Sales of Life Interests.* Mr. Surrey would change the law now applied to sale of life interests. His proposal is to deny any basis, treat the entire proceeds as ordinary income, and attempt to avoid "lumping" into one tax year income which absent sale would have been received over many years. The latter result would be accomplished by applying a marginal rate ascertained from the taxpayer's marginal rates in the five years preceding sale. If this deters sales of life interests, Mr. Surrey is not worried because he does not see any reason why life tenants should sell their interests.¹³⁴

4. *Deferred Compensation.* Finally, Mr. Surrey is concerned with the avoidance devices in the corporate executive compensation area. Most of these have been treated earlier—new laws for stock options and pension trust terminations and tougher enforcement in the fringe benefit area. In addition, he believes that individual deferred-compensation plans should be subjected to coverage requirements similar to those now imposed upon tax-benefited non-discriminatory pension plans.¹³⁵

H. *The Low-Bracket Shelters*

There are certain tax preferences benefiting primarily low-bracket taxpayers. These, too, have been criticized. Slated for elimination if the new officials both have their way are the sick-pay exclusion, the retirement income credit, and the exemption of Social Security payments.¹³⁶ Mr. Caplin would eliminate the retirement income credit but does not discuss the exclusion of Social Security payments.¹³⁷ In view of the creation of the retirement income credit partially for the purpose of equalizing treatment of those who do and those who do not receive Social Security,¹³⁸ his proposal is subject to the criticism that it simply

¹³¹ INT. REV. CODE OF 1954, § 2039 (a).

¹³² INT. REV. CODE OF 1954, § 2039 (c).

¹³³ Surrey, *supra* note 105, at 438, 439.

¹³⁴ Surrey, *supra* note 105, at 441.

¹³⁵ Surrey, *supra* note 25, at 822 n.31.

¹³⁶ Caplin, *supra* note 2, at 845, 846; Surrey, *supra* note 25, at 823.

¹³⁷ Caplin, *supra* note 2, at 845, 846.

¹³⁸ Surrey, *supra* note 25, at 823.

restores the previous inequity. Mr. Surrey's suggestion of eliminating both benefits would produce more horizontal equity in the tax system.¹³⁹ Mr. Surrey doubts generally the wisdom of favoring elderly taxpayers with an extra exemption, extra medical deduction allowance, the retirement income credit, and the Social Security exclusion.¹⁴⁰ Furthermore, he is concerned with exemption, often at the behest of organized labor, of wage earners' fringe benefits. He apparently would halt the trend toward exempting more fringe benefits and where possible would reverse it. He proposes serious study of the conceptual and administrative problems involved in the present exemption of employer-paid medical expenses and board and lodging, and the problems which will be involved if company-paid vacations and the like become more common.¹⁴¹ Mr. Surrey advocates elimination of the child care deduction as being minor, complicated, and only on the borderline of business expenses. However, he does not consider this a first order of business.¹⁴²

I. *A New Tax Court and a New Code*

Finally, in the area of specific reforms, Mr. Caplin proposes study of the need for a court of tax appeals to dispose finally of all but constitutional issues in tax litigation, and the need for a paid commission to study thoroughly the possibility of drafting a new code.¹⁴³

V. CONCLUSION: A LOWER RATE STRUCTURE PLUS BROADENING OF THE TAX BASE

Mr. Surrey estimates that his increases in the tax base would produce approximately an extra twelve billion dollars at present rates and that his proposed reduced rate structure applied to his proposed new base would bring in approximately the same total revenue as is now received.¹⁴⁴ This rate structure would have a top rate of approximately sixty-five percent with the other rates reduced by approximately twenty-five percent from today's level.¹⁴⁵

¹³⁹ *Ibid.*

¹⁴⁰ *Ibid.*

¹⁴¹ Surrey, *supra* note 25, at 824.

¹⁴² Surrey, *supra* note 25, at 826.

¹⁴³ Caplin, *supra* note 2, at 853.

¹⁴⁴ Surrey, *supra* note 25, at 829.

¹⁴⁵ *Ibid.*

Mr. Surrey would consider, and Mr. Caplin proposes, a splitting of the bottom bracket with a ten percent bottom rate on the first two thousand dollars of taxable income.¹⁴⁶ Both officials advocate introduction of some type of averaging provision for ordinary income.¹⁴⁷

While Mr. Surrey estimates that the effect of the increase in the tax base would be equivalent to the effect of the lower rates when total revenue is considered, he does not give any estimated comparison of the two effects for particular income brackets. In other words, he does not give an opinion on whether the average amount paid by individual taxpayers in a particular bracket would be more or less if his proposals were adopted. The tax shelters he attacks are by no means evenly distributed up and down the rate scale, but are concentrated in the high-bracket areas, with the result that the actual average effective rates in the high brackets are already substantially below the stated rates.¹⁴⁸ One can imagine that legislators of all political hues would be interested in knowing whether the average amount paid by individual high and low bracket taxpayers will actually be more or less if the proposed legislation is adopted. The late Randolph Paul, in proposing substantially similar reforms, indicated that if they were enacted most high bracket taxpayers would actually pay more in total taxes.¹⁴⁹

The stated reason of the two men for their proposals is a present and increasing ineffectiveness of the income tax caused primarily by the difficulty of administration and low taxpayer morale.¹⁵⁰ Numerous other writers have advanced similar proposals for similar reasons.¹⁵¹ However, not all authorities agree on the reasons for the reforms. Walter J. Blum, Chicago University tax specialist, sees neither a noticeable drop in taxpayer morale nor great difficulties in administration of the law. In his opinion, the most vociferous supporters of a broadening of the tax base are those who

¹⁴⁶ Caplin, *supra* note 2, at 845; Surrey, *supra* note 25, at 830.

¹⁴⁷ Caplin, *supra* note 2, at 846; Surrey, in 1955 *Hearings* 314; Surrey, *supra* note 24, at 1018.

¹⁴⁸ Surrey, *supra* note 25, at 815, 816; Musgrave, *How Progressive Is the Income Tax*, in 3 1959 COMPENDIUM 2223, 2230.

¹⁴⁹ Paul, *Erosion of the Tax Base and the Rate Structure*, 11 TAX L. REV. 203, 220 (1956).

¹⁵⁰ Caplin, *supra* note 2, at 839, 840; Surrey, *supra* note 2, at A3053.

¹⁵¹ See, e.g., the bibliography given in Surrey, *supra* note 25, at 817 n.14 and in Surrey, *supra* note 4, at 1146 n.3.

desire, or feel the inevitability of, greater federal expenditures in the near future and want an effective instrument for raising the revenue. He claims personally to favor base broadening and rate lowering solely on grounds of fairness. Blum sees at present an uneasy alliance between those who want primarily a broader base and those who want primarily lower rates, and doubts the stability of the alliance.¹⁵² His comments raise the question of the likelihood of enactment of the proposed changes.

Mr. Surrey has anticipated certain of the political reactions to his suggestions. He believes the problem attacked to be one common to all nations with progressive income taxation and notes that conservatives have generally been fairly effective in legislating shelters from high rates. The conservative, says Mr. Surrey, favors lower rates; but elimination of tax shelters with no effective safeguard against renewal of high rates leaves the wealthy taxpayer in danger of a much more painful tax bite than ever suffered before.¹⁵³ The conservative viewpoint anticipated by Mr. Surrey has already been voiced by the president of the National Association of Real Estate Boards, who asks, "What assurances would the American people have that once they had given up all these deductions, the next Congress wouldn't start pushing up the rates to meet the cost of expanding the welfare state?"¹⁵⁴

Mr. Surrey believes the liberal to be in no less a dilemma on the question of reducing rates in return for base-broadening. The liberal legislator must explain to his constituents a most obvious rate cut from ninety-one percent to sixty-five percent on the incomes of the very wealthy, in return for elimination of shelters whose nature is comprehended only vaguely, if at all.¹⁵⁵ Apparently Mr. Surrey fears intransigent opposition by organized labor; he has spent some time contending that if labor does not make compromises to improve the income tax it will face a federal sales tax.¹⁵⁶

Finally, every tax shelter attacked is defended by a vociferous and powerful pressure group. Their combined influences focused

¹⁵² Blum, *Tax Policy and Preferential Provisions in the Income Tax Base*, in 1 1959 COMPENDIUM 77-78, 81. For an example of one who wants reform in order to improve the revenue-raising capacity, see Mills, *Preface to Federal Taxation 1958*, 44 VA. L. REV. 835, 837 (1958).

¹⁵³ Surrey, *supra* note 4, at 1150.

¹⁵⁴ Powell, *Wall St. Journal*, April 3, 1960, p. 14, col. 5.

¹⁵⁵ Surrey, *supra* note 4, at 1150.

¹⁵⁶ Surrey, *supra* note 2, at A3055.

on a congressman could be awesome indeed. The consideration of all of the difficulties facing large-scale base-broadening and rate reduction led Professor Blum to predict, in a congressional study of the matter in 1959, that the ensuing year would see more tax havens rather than fewer, in the Internal Revenue Code.¹⁵⁷

David G. Hill, S.Ed.

¹⁵⁷ Blum, *supra* note 152, at 82.